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DESCRIPTION OF PROPOSALS RELATING TO THE FEDERAL INCOME TAX TREATMENT OF CERTAIN INTANGIBLE PROPERTY (H.R. 3035, H.R. 1456, AND H.R. 563)

SCHEDULED FOR HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON OCTOBER 2 and 29, 1991

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled public hearings on October 2 and 29, 1991, on proposals relating to the Federal income tax treatment of certain intangible property. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law tax rules and the three bills listed for the hearing (H.R. 3035, H.R. 1456, and H.R. 563), and a discussion of issues related to the Federal income tax treatment of intangible property and to these bills.

Part I of the pamphlet is a summary of present law and the three bills listed for the hearing. Part II provides a more detailed description of the present-law tax rules relating to intangible assets and background on such tax rules and related executive and judicial interpretations. Part III provides a more detailed description of the three bills: H.R. 3035 (introduced by Chairman Rostenkowski); H.R. 1456 (introduced by Mr. Vander Jagt, Mr. Anthony, and Mrs. Kennelly); and H.R. 563 (introduced by Mr. Donnelly). Part IV provides a discussion of issues related to the Federal income tax treatment of intangible assets and the three bills.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Proposals Relating to the Federal Income Tax Treatment of Certain Intangible Property (H.R. 3035, H.R. 1456, and H.R. 563)* (JCS-14-91), September 30, 1991.

I. SUMMARY

Present law

In determining taxable income for Federal income tax purposes, taxpayers are allowed depreciation deductions for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or that is held for the production of income. Under Treasury Department regulations, no depreciation deductions are allowed with respect to intangible property unless the intangible property has a limited useful life that may be determined with reasonable accuracy. In addition, under the same Treasury Department regulations, no depreciation deductions are allowed with respect to goodwill or going concern value.

Numerous court decisions and Internal Revenue Service pronouncements have addressed whether depreciation deductions are allowed with respect to intangible property. In general, a taxpayer must establish that the intangible property is distinguishable from goodwill or going concern value and that the intangible property has a limited useful life that is determinable with reasonable accuracy. Because this is essentially a factual determination, different results have often been reached in different cases with respect to the same or similar types of intangible property.

H.R. 3035 (Chairman Rostenkowski)

H.R. 3035 would allow an amortization deduction with respect to goodwill, going concern value, and certain other intangible property that is acquired by a taxpayer and that is held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. The amount of the deduction would be determined by amortizing the adjusted basis of the intangible ratably over a 14-year period.

H.R. 3035 generally would apply to specifically defined intangible property whether acquired as part of the acquisition of a trade or business or as a single pre-existing asset. The bill would not change the Federal income tax treatment of self-created intangible property, such as goodwill that is created through advertising or other similar expenditures.

H.R. 3035 would apply to property acquired after the date of enactment.

H.R. 1456 (Mr. Vander Jagt, Mr. Anthony, and Mrs. Kennelly)

H.R. 1456, the "Intangibles Amortization Clarification Act of 1991," would amend section 167 of the Internal Revenue Code to provide that the value of customer based, market share, and any similar intangible items are amortizable over their useful life if the taxpayer can demonstrate through any reasonable method that (1) the intangible items have an ascertainable value that is separate

and distinct from other assets (including goodwill and going concern value), if any, acquired as part of the same transaction, and (2) the intangible items have a limited useful life, the length of which can be reasonably estimated.

In addition, H.R. 1456 would grant the Treasury Department the authority to promulgate regulations establishing safe harbor recovery periods that are consistent with industry practice and experience for specific types of customer based, market share, and any similar intangible items, and regulations concerning the manner in which such intangible items may be valued separately and distinctly from other assets (including goodwill and going concern value).

H.R. 1456 would apply to all open taxable years (i.e., all taxable years for which the statute of limitations has not expired).

H.R. 563 (Mr. Donnelly)

H.R. 563 would amend section 167 of the Internal Revenue Code to provide that in determining whether an income tax deduction is allowed for any amount that is paid or incurred to acquire customer base, market share, or any similar intangible item, the amount is to be treated as paid or incurred for intangible property with an indeterminate useful life. Consequently, no depreciation or amortization deduction would be allowed under the bill for the cost of acquiring customer base, market share, or other similar intangible property.

H.R. 563 would apply to acquisitions that occur after the date of enactment.

II. BACKGROUND AND PRESENT LAW

In general

Under section 167 of the Internal Revenue Code, taxpayers are allowed depreciation deductions for the exhaustion, wear and tear, and obsolescence of property that is used in a trade or business or that is held for the production of income. Under Treasury Department regulations, no depreciation deductions are allowed with respect to intangible property unless the intangible property has a limited useful life that may be determined with reasonable accuracy.[2] In addition, under the same Treasury Department regulations, no depreciation deductions are allowed with respect to goodwill.

Thus, in order for depreciation or amortization [3] deductions to be allowed for Federal income tax purposes with respect to intangible property, a taxpayer generally must establish that the property is distinguishable from goodwill and that the property has a limited useful life that is determinable with reasonable accuracy. Numerous court decisions and Internal Revenue Service pronouncements have addressed whether these requirements have been satisfied with respect to different types of intangible property. The determination whether depreciation deductions are allowed with respect to intangible property is dependent on all the facts and circumstances. In certain situations, however, the Internal Revenue Service and some courts have suggested that certain results should be considered a matter of law. Often, different results have been reached in different cases with respect to the same or similar types of intangible property.

Issues regarding the amortization of intangible assets frequently arise in the context of the acquisition of a business enterprise. If the price paid to acquire a trade or business exceeds the value of the tangible assets of the trade or business, the purchaser generally must allocate such excess either to (1) goodwill or going concern value, which are not depreciable or amortizable for Federal income tax purposes, or (2) other intangible assets, which may be depreciable or amortizable for Federal income tax purposes.[4]

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[2] Treas. Reg. sec. 1.167(a)-3 provides that:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

[3] The deductions allowed for the exhaustion, wear and tear, and obsolescence of intangible property that is used in a trade or business or that is held for the production of income are often referred to as amortization deductions.

[4] See section 1060 of the Code and the regulations thereunder which provide rules for the allocation of the purchase price among assets in the case of certain acquisitions occurring after May 6, 1986.

The following discussion illustrates some of the issues and inconsistencies that arise under present law.

Treatment of certain customer-based intangibles

Taxpayers that have acquired a trade or business have often allocated a portion of the purchase price to customer lists, subscription lists, client records, and other similar intangible assets that represent the customer base of the trade or business. A recurring issue for Federal income tax purposes has been whether a value and life for such intangible assets can be identified that is separate and distinct from goodwill, which generally has been defined as "the expectancy that old customers will resort to the old place" [5] or "the expectancy of continued patronage, for whatever reason." [6]

In a number of cases decided prior to 1973, the courts generally held that customer lists and other similar customer-based intangibles are "related to" or "in the nature of" goodwill and, consequently, no depreciation or amortization deductions are allowed with respect to such assets. In many of these cases, the Internal Revenue Service successfully argued that such customer-based intangibles are "mass assets," the value of which may fluctuate as particular customers are lost and others replace them. These mass assets were considered to provide an inexhaustible benefit and have an indefinite useful life.

For example, in *Golden State Towel and Linen Service, Ltd. v. United States*,[7] the Court of Claims denied a depreciation or loss deduction with respect to a customer list that was acquired in connection with the purchase of the assets of a linen business. The court held that a terminable-at-will customer list is an indivisible asset that is indistinguishable from goodwill. The court found that while the list is subject to temporary attrition as well as expansion due to the departure of old customers and the addition of new customers, no deduction is allowed for Federal income tax purposes for the normal turnover of customers.[8]

In 1973, however, the Fifth Circuit Court of Appeals in *Houston Chronicle Publishing Company v. United States* [9] held that the "mass asset" theory does not preclude depreciation or amortization deductions with respect to customer-based intangibles. In Houston Chronicle the taxpayer acquired lists of newspaper subscribers in connection with the acquisition of the tangible assets of a newspaper publishing company. The newspaper of the acquired publishing company was not published after the acquisition. The court held

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[5] *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963).

[6] *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962). See, also, *Newark Morning Ledger Co. v. United States*, No. 90-5637 (3rd Cir. 1991).

[7] 373 F.2d 938 (Ct. Cl. 1967).

[8] See, also, *Danville Press, Inc. v. Commissioner*, 1 B.T.A. 1171 (1925) (no depreciation deductions allowed with respect to newspaper subscribers); *Boe v. Commissioner*, 35 T.C. 720 (1961), *aff'd* 307 F.2d 339 (9th Cir. 1962) (no depreciation or loss deductions allowed with respect to medical service contracts); *Westinghouse Broadcasting Co. v. Commissioner*, 36 T.C. 912 (1961) (no depreciation deductions allowed with respect to spot advertising contracts); *Scalish v. Commissioner*, 21 T.C.M. 260 (1962) (no depreciation deductions allowed with respect to cigarette vending machine location leases); *Thoms v. Commissioner*, 50 T.C. 247 (1968) (no depreciation deductions allowed with respect to insurance expirations); and *Marsh & McLennan, Inc. v. Commissioner*, 51 T.C. 56 (1968), *aff'd* 420 F.2d 667 (3rd Cir. 1970) (same). But, see, *Seaboard Finance Co. v. Commissioner*, 367 F.2d 646 (9th Cir. 1966) (depreciation deductions allowed with respect to favorable loan contracts).

[9] 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

that depreciation deductions are allowed with respect to an intangible asset if the taxpayer establishes that (1) the intangible asset has an ascertainable value that is separate and distinct from goodwill and (2) the intangible asset has a limited useful life, the duration of which can be ascertained with reasonable accuracy. A jury verdict finding that the taxpayer had satisfied these requirements was thus permitted to stand.

Following the decision in *Houston Chronicle*, the Internal Revenue Service issued Rev. Rul. 74-456.[10] The ruling stated that, in general, customer lists and certain similar items represent the customer structure of a business and are in the nature of goodwill. However, the ruling also stated that, if, in an unusual case, an intangible asset or a portion thereof does not possess the characteristics of goodwill, is susceptible of valuation, and is of use to the taxpayer in its trade or business for only a limited period of time, a depreciation deduction is allowable. The ruling cited the *Houston Chronicle* case and other cases.

Notwithstanding the abandonment of an absolute mass-asset theory by the Internal Revenue Service as evidenced by the issuance of Rev. Rul. 74-456, litigation concerning the treatment of customer-based intangibles has continued as a matter of facts and circumstances, with some courts holding for taxpayers by allowing depreciation or amortization deductions with respect to certain types of customer-based intangibles and other courts holding for the Internal Revenue Service by denying depreciation or amortization deductions with respect to the same types of customer-based intangibles.

For example, in *Donrey, Inc. v. United States*,[11] the Eighth Circuit Court of Appeals held that a subscription list that was acquired in connection with the purchase of the assets of a newspaper publishing company was amortizable if the taxpayer established a value for the subscription list that was separate and distinct from goodwill and the taxpayer established a useful life for the subscription list.[12] A jury verdict finding that these facts had been established was allowed to stand.[13]

However, in *Newark Morning Ledger Co. v. United States*,[14] the Third Circuit Court of Appeals, reversing a district court decision, held that subscription lists acquired in connection with the acquisition of the assets of a newspaper publishing company were not depreciable. The circuit court concluded that the district court had applied an improper definition of goodwill and that the decision of the district court in concluding that the taxpayer had proven a value separate and apart from goodwill was clearly erroneous.[15]

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[10] 1974-2 C.B. 65.

[11] 809 F.2d 534 (8th Cir. 1987).

[12] See, also, *Panichi v. United States*, 834 F.2d 300 (2nd Cir. 1987) (depreciation deductions allowed with respect to list of trash collection customers).

[13] It is interesting to note that, unlike the *Houston Chronicle* case, the newspaper of the acquired publishing company continued to be published by the acquirer.

[14] No. 90-5637 (3rd Cir. 1991), *rev'g* 734 F. Supp. 176 (D. N.J. 1990).

[15] The circuit court observed that the taxpayer's value was determined by reference to the expected income from future patronage of the customers on the list, rather than by reference to the estimated cost of replacing the customer list. Although the court did not hold that the latter valuation method would necessarily have been sustained, it observed that the method used created a value not distinguishable from goodwill.

The circuit court stated that "we believe that the Service is correct in asserting that, for tax purposes, there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable." It further stated that "customer lists are generally not depreciable when acquired in conjunction with the sale of the underlying business as a going concern." [16]

As another example of conflicting court decisions involving apparently similar assets, several courts have considered the Federal income tax treatment of the costs of acquiring insurance expirations, which are the records maintained by insurance agents with respect to insurance customers and which generally include such information as the type of insurance, the amount of insurance, and the expiration date of the insurance.[17] In *Richard S. Miller & Sons, Inc. v. United States*,[18] the taxpayer was allowed a depreciation deduction with respect to the portion of the purchase price of an insurance agency that was allocable to insurance expirations.[19] On the other hand, in *Decker v. Commissioner*,[20] the Seventh Circuit Court of Appeals affirmed a Tax Court decision that denied a depreciation deduction with respect to insurance expirations that were acquired in connection with the purchase of an insurance agency. The Tax Court held that the insurance expirations were inextricably linked to goodwill principally due to the fact that the purchaser continued the operation of the acquired insurance agency with little change.[21]

Similar inconsistent results have occurred with respect to the treatment of "core deposits," which generally include the checking account, savings account and other similar deposits of a bank that may be withdrawn at will by depositors. In *AmSouth Bancorporation v. United States*,[22] a district court held that although the deposits themselves were identifiable, any value created by the expectation that they would continue was not a value separate and distinct from goodwill and, consequently, no depreciation or amortization deductions were allowed. On the other hand, in *Citizens & Southern Corp. v. Commissioner* [23] *and Colorado National Bankshares, Inc. v. Commissioner*,[24] the Tax Court allowed depreciation deductions with respect to core deposits because the taxpayer established that the core deposits had an ascertainable value that was separate and distinct from goodwill and the core deposits had a limited useful life that could be determined with reasonable accuracy.

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[16] ——F.2d ——, —— (3rd Cir 1991); BNA Daily Tax Report, September 17, 1991, at p. K-7.

[17] Insurance expirations are valuable to an insurance agency because they enable the agency to contact each policyholder at or near the expiration of the insurance coverage with full knowledge of the type, terms, and history of the existing coverage.

[18] 537 F.2d 446 (Ct. Cl. 1976).

[19] See, also, *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223 (1975) (acq.) (depreciation deductions allowed with respect to credit information files); and *Los Angeles Central Animal Hospital, Inc. v. Commissioner*, 68 T.C. 269 (1977) (depreciation deductions allowed with respect to medical records of a veterinary hospital).

[20] 864 F.2d 51 (7th Cir. 1988), *aff'g*, 54 T.C.M. 338 (1987).

[21] 54 T.C.M. 338 (1987) *aff'd.* 864 F.2d 51 (7th Cir. 1988).

[22] 681 F. Supp. 698 (N.D. Ala. 1988).

[23] 91 T.C. 463 (1988), *aff'd* 900 F.2d 266 (11th Cir. 1990).

[24] 60 T.C.M. 771 (1990).

On January 30, 1990, the Internal Revenue Service issued an Industry Specialization Program coordinated issue paper that discusses the depreciation of customer-based intangibles. The paper concludes that if an ongoing business is acquired with the expectation of continued patronage of the seller's customers such that the purchaser merely steps into the shoes of the seller and the business possesses characteristics of goodwill, then any customer-based intangible acquired in connection with such purchase is inseparable from goodwill and, thus, is not amortizable as a matter of law.

Treatment of certain workforce-based intangibles

Taxpayers that have acquired an ongoing trade or business have also allocated a portion of the purchase price to assets such as agency force, assembled workforce, or other similar workforce-based intangibles. These intangible assets are generally said to represent the value of having a trained, experienced workforce in place as of the date of acquisition (as opposed to having to hire and train a workforce). Unlike customer-based intangibles, the Federal income tax treatment of workforce-based intangibles has not yet resulted in many court decisions.[25] According to a recent report issued by the General Accounting Office (GAO),[26] however, for the 1979 through 1987 taxable years, the Internal Revenue Service proposed income tax adjustments of $866 million with respect to workforce-based intangibles.

On January 30, 1990, the Internal Revenue Service issued an Industry Specialization Program coordinated issue paper which stated that "any value associated with having a trained staff of employees in place represents the going concern value of an acquired business" and, consequently, the portion of the purchase price of an acquired trade or business that is allocable to the trained workforce is not amortizable. This position of the Internal Revenue Service was recently upheld by the Tax Court in *Ithaca Industries, Inc. v. Commissioner.*[27] In *Ithaca Industries, Inc.*, the taxpayer allocated $7.7 million of a total purchase price of $160 million to the assembled workforce of an underwear manufacturer. The Tax Court held that the assembled workforce of the taxpayer's trade or business was not a wasting asset separate and distinct from going concern value and, consequently, the portion of the purchase price allocable to the assembled workforce was not amortizable for Federal income tax purposes.

Treatment of government rights of an indefinite duration

Taxpayers generally have not been allowed depreciation or amortization deductions with respect to renewable rights that are grant-

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[25] Taxpayers generally have been allowed depreciation deductions with respect to employment contracts. See, e.g., Rev. Rul. 67-379, 1967-2 C.B. 127 (professional baseball player contracts depreciable); Rev. Rul. 71-137, 1971-1 C.B. 104 (professional football player contracts depreciable); and *KFOX, Inc. v. United States*, 510 F.2d 1365 (Ct. Cl. 1975) (radio disc jockey contracts depreciable). But, see, *National Service Industries, Inc. v. United States* 379 F.Supp 831 (N.D. Ga. 1973) (employee contracts not depreciable in absence of proof of value or useful lives); and *Forman, Inc. v. United States*, 89-1 U.S.T.C. Par. 9165 (D.Md. 1989) ("advantageous" union contract not depreciable).

[26] *Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets*, Report to the Joint Committee on Taxation by the General Government Division of the General Accounting Office (GAO/GGD-91-88), August 19, 1991, (hereinafter referred to as the GAO Report) p. 4.

[27] 97 T.C. No. 16 (August 12, 1991).

ed by a governmental entity because a useful life for the rights generally is not determinable with reasonable accuracy. For example, in *KWTX Broadcasting Co. v. Commissioner*,[28] the Tax Court denied depreciation deductions with respect to a 3-year license issued by the Federal Communications Commission (FCC) to operate a television broadcasting station. The court's holding was based on the fact that the FCC had never refused to renew a license, and, consequently, the license was considered to be of an indefinite duration.[29]

In addition, in *Nachman v. Commissioner*,[30] the Fifth Circuit Court of Appeals denied depreciation deductions with respect to the premium paid for a retail liquor license that was valid for only 5 months after the date of acquisition. The court held that the useful life of the liquor license was likely to continue indefinitely because it was the established practice in issuing renewal licenses to favor the holders of existing licenses over other applicants.[31] Similarly, in *Toledo TV Cable Co. v. Commissioner*,[32] the taxpayer was not allowed depreciation deductions with respect to cable television franchises granted by a governmental entity because the taxpayer failed to establish that the franchises had a determinable useful life.

On the other hand, in *Chronicle Publishing Co. v. Commissioner*,[33] the taxpayer was allowed depreciation deductions with respect to cable television franchises because the taxpayer was able to establish useful lives for the franchises that were determinable with reasonable accuracy. In *Chronicle Publishing Co.*, the franchises did not contain renewal options or other renewal provisions and no practice or custom of granting renewals had been established.

In *Tele-Communications, Inc. v. Commissioner*,[34] the taxpayer asserted in the course of the examination of the taxpayer's income tax return that the rights to operate a cable television system that were granted by a local governmental unit should constitute a franchise for purposes of section 1253 of the Internal Revenue Code and, thus, should be eligible for the special cost recovery rules under section 1253. The Tax Court concluded that section 1253 applied to the cable television rights, and, consequently, the taxpayer was allowed amortization deductions with respect to the cost of acquiring the cable television rights from the prior operator of the cable television system, even though the rights may extend for an indefinite period.

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[28] 31 T.C. 952 (1959), *aff'd per curiam*, 272 F.2d 406 (5th Cir. 1959).

[29] See, also, *Richmond Television Corp. v. United States*, 354 F.2d 410 (4th Cir. 1965), *vacated and remanded on other grounds*, 382 U.S. 68 (1965) (depreciation deductions not allowed with respect to cost of training personnel for a new television station because FCC license had an indefinite useful life); Rev. Rul. 56-520, 1956-2 C.B. 170 (depreciation deductions not allowed with respect to cost of FCC license to operate a television broadcasting station); and Rev. Rul. 64-124, 1964-1 (Part 1) C.B. 105 (same).

[30] 191 F.2d 934 (5th Cir. 1951).

[31] See, also, *Shufflebarger v. Commissioner*, 24 T.C. 980 (1955) (depreciation deductions not allowed with respect to grazing privileges because the taxpayer was unable to establish a useful life due to a preferential right to renew such privileges); and *Uecker v. Commissioner*, 81 T.C. 983 (1983), *aff'd per curiam*, 766 F.2d 909 (5th Cir. 1985) (same).

[32] 55 T.C. 1107 (1971), *aff'd per curiam*, 483 F.2d 1398 (9th Cir. 1973).

[33] 67 T.C. 964 (1977), *appeal dismissed* (Dec. 22, 1977), *nonacq.* 1980-1 C.B. 2.

[34] 95 T.C. 495 (1990), appeal filed with the Tenth Circuit Court of Appeals.

Treatment of franchises, trademarks, and trade names

Apart from the application of section 1253 of the Internal Revenue Code, various cases have held that the cost of acquiring a franchise, trademark, or trade name was not depreciable or amortizable because the taxpayer was unable to establish that (1) the franchise, trademark, or trade name was distinguishable from goodwill or (2) the franchise, trademark, or trade name had a limited useful life that was determinable with reasonable accuracy.

For example, in *Clark Thread Co. v. Commissioner*,[35] the court denied a deduction for the cost of securing a competitor's agreement to discontinue the use of a trade name based on the court's conclusion that trade names are like goodwill in their economic characteristics and effect. The court stated that goodwill and trade names may vary in value through the years but will be of ongoing usefulness indefinitely. As a further example, in *Dunn v. United States*,[36] the Tenth Circuit Court of Appeals held that various payments made in connection with a "Dairy Queen" franchise were not amortizable because the taxpayer failed to establish a useful life for the franchise agreement.

Where a useful life has been established with reasonable accuracy, depreciation deductions have been allowed with respect to a franchise. For example, in *Chronicle Publishing Co. v. Commissioner*,[37] depreciation deductions were allowed with respect to cable television franchises because the taxpayer established useful lives for the franchises.[37a]

Section 1253 provides special rules with respect to payments made on account of the transfer of a franchise, trademark, or trade name. Under section 1253, the acquiror of a franchise, trademark or trade name generally may amortize the cost of acquiring such an asset over the useful life of the asset if a useful life may be established with reasonable accuracy. In addition, taxpayers may elect under certain circumstances to amortize the cost of acquiring a franchise, trademark, or trade name over 25 years (even if a useful life cannot be established). In addition, an amortization period of 10 years (rather than 25 years) is provided for certain small transactions (i.e., those transactions involving fixed-sum amounts that do not exceed $100,000).[38]

Although the 25-year (or 10-year) periods of section 1253 do not explicitly apply to a franchise that is sold by one franchisee to another in a transaction that would be eligible for capital gains treatment,[39] the Internal Revenue Service ruled in Rev. Rul. 88-24 [40]

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[35] 100 F.2d 257 (3rd Cir. 1939).

[36] 400 F.2d 679 (10th Cir. 1969).

[37] 67 T.C. 964 (1977), *appeal dismissed* (Dec. 22, 1977), *nonacq.* 1980-1 C.B. 2.

[37a] Compare, *Toledo TV Cable Co. v. Commissioner*, 55 T.C. 1107 (1971), *aff'd per curiam*, 483 F.2d 1398 (9th Cir. 1973) (depreciation deductions with respect to cable television franchises were denied because the taxpayer did not establish that the franchises had a determinable useful life.)

[38] Prior to the enactment of the Omnibus Budget Reconciliation Act of 1989, a 10-year amortization period, rather than a 25-year period, generally applied to all transactions including those with fixed-sum amounts in excess of $100,000.

[39] The election of a 25-year amortization period applies where the transfer of a franchise, trademark, or trade name is "not ... treated as a sale or exchange of a capital asset" by reason of section 1253(a), which denies such treatment to a transferor "if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name." Secs. 1253(d)(2) and (3), 1253(a).

[40] 1988-1 C.B. 306.

that section 1253 applies in such a case if the franchisor retains a significant power, right, or continuing interest with respect to the subject matter of the franchise. Accordingly, if a franchise under which the franchisor retains such rights is sold by one franchisee to another, the portion of the purchase price that is attributable to the franchise is generally amortizable over the lesser of 25 years or the useful life, if a shorter life can be established with reasonable accuracy.

In addition, under section 1253, an ordinary and necessary business expense deduction is allowed for any amount that is contingent on the productivity, use, or disposition of a franchise, trademark, or trade name if the amount is paid as part of a series of payments that (1) are payable at least annually throughout the term of the transfer agreement, and (2) are substantially equal in amount or are payable under a fixed formula.

Disputes have arisen regarding what assets may properly be considered "franchises" within the meaning of section 1253 and, thus, be entitled to the favorable 25-year (or 10-year) amortization election that applies in the absence of an ascertainable useful life. The Internal Revenue Service has contended, for example, that governmental rights cannot qualify as franchises for this purpose. The Tax Court rejected this argument in *Tele-Communications, Inc. v. Commissioner.*[41] Disputes also have arisen as to whether particular arrangements between private parties constitute a franchise for purposes of section 1253. For example, the issue whether certain television network affiliation contracts qualify for the cost recovery provisions of section 1253 has been raised in several pending cases.

Finally, disputes have arisen regarding what portion, if any, of the purchase price of an acquired trade or business is properly attributable to the "franchise" as distinct from some other going concern element of a franchised business.[42]

Treatment of covenants not to compete

As part of the sale of a trade or business, the purchaser and seller often enter into an agreement frequently stated to be for some fixed time period pursuant to which the seller agrees not to compete with the trade or business acquired by the purchaser. As in the case of other intangible assets, depreciation deductions are allowed with respect to a covenant not to compete only if the covenant is distinguishable from goodwill and the covenant has a useful life that is determinable with reasonable accuracy.

The issues of (1) whether a covenant not to compete is depreciable for Federal income tax purposes and (2) what portion of the purchase price of an acquired trade or business is allocable to a covenant not to compete have been the subject of numerous disputes between taxpayers and the Internal Revenue Service. In many cases, the purchaser and the seller have not assigned any purchase price to the covenant not to compete. The courts generally have not allowed depreciation deductions with respect to a cov-

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[41] 95 T.C. 495 (1990), appeal filed with the Tenth Circuit Court of Appeals.

[42] See, e.g., *Tele-Communications, Inc.* v. *Commissioner*, 95 T.C. 495 (1990) (Tax Court agreed with one of taxpayer's two experts regarding the amount properly allocable to going concern value or some other nonamortizable asset distinct from a franchise); and *Nachman* v. *Commissioner*, 191 F.2d 934 (5th Cir. 1951).

enant not to compete if no portion of the purchase price has been specifically assigned to the covenant.[43] If, on the other hand, the amount paid for a covenant not to compete has been separately bargained for and has a basis in economic reality, the courts have generally respected the purchase price allocation, particularly where the parties have had adverse tax interests with respect to the allocation.[44]

Prior to the enactment of the Tax Reform Act of 1986, the seller and the purchaser of a trade or business generally had significant adverse interests with respect to the allocation of purchase price to a covenant not to compete. There was a significant difference in the tax rates on capital gains and on ordinary income. In addition, corporate-level capital gain was generally tax-free under the rules relating to corporate liquidations. The adversity arose because the amount received by a seller under a covenant not to compete generally is treated as ordinary income, while the remaining amount of the purchase price was generally treated as capital gain. For the purchaser, the amount paid for the covenant not to compete generally was amortizable over the relatively short term of the covenant, while the remaining amount of the purchase price was allocated to longer lived depreciable assets or to nondepreciable assets. With the elimination of a significant preference for long-term capital gains and the repeal of the tax-free treatment of corporate level capital gain, the purchaser of a trade or business still frequently has an interest in allocating purchase price to the covenant not to compete but the seller no longer has a significant adverse interest. Anecdotal evidence from some taxpayers and practitioners suggests that the amount of the purchase price of an acquired trade or business that is allocated to a covenant not to compete may have increased in some situations since the enactment of the Tax Reform Act of 1986.

Treatment of patents and copyrights

The Treasury Department regulations relating to the depreciation of intangible property provide that patents and copyrights are types of intangible property with respect to which depreciation deductions are allowed for Federal income tax purposes.[45] The legal life of a patent issued by the United States Patent Office is 17 years, while the legal life of a copyright generally extends for the life of the author plus 50 years. The cost of acquiring a patent or copyright, however, need not be amortized over the remaining legal

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[43] See, e.g., *Delsea Drive-In Theatres, Inc. v. Commissioner*, 379 F.2d 316 (3rd Cir. 1967); and *General Insurance Agency, Inc. v. Commissioner*, 401 F.2d 324 (4th Cir. 1968). See, also, *Forward Communications Corp. v. United States*, 608 F.2d 485 (Ct. Cl. 1979), in which it was stated as a fact that a 5-year period for a covenant was chosen because the taxpayer felt that after that period the seller would lose its effectiveness in the relevant market. The court concluded that the covenant was not a separable wasting asset, but merely protective of the goodwill that the taxpayer acquired in the purchase.

[44] See, e.g., *Christensen Machine Co. v. Commissioner*, 18 B.T.A. 256 (1929); *Commissioner v. Gazette Telegraph Co.*, 209 F.2d 926 (10th Cir. 1954); and *United Elchem Industries, Inc. v. Commissioner*, 42 T.C.M. 460 (1981). See, also, *Ullman v. Commissioner*, 264 F.2d 305 (2nd Cir. 1959); and *Commissioner v. Danielson*, 378 F.2d 771 (3rd Cir. 1967), *cert. denied*, 389 U.S. 858. Code section 1060(a), as amended by the Omnibus Budget Reconciliation Act of 1990, forbids parties who agree in writing as to the allocation of consideration to challenge the allocation unless certain standards of the *Danielson* case are satisfied. The Treasury, however, may challenge the allocation.

[45] Treas. Reg. sec. 1.167(a)-3.

life of the patent or copyright as of the date of acquisition. Instead, a taxpayer may establish that the useful life of the patent or copyright is shorter than the legal life, in which case the cost of the patent or copyright would be recovered over such shorter period. If the purchase price of a patent is payable on an annual basis as a fixed percentage of the revenue derived from the use of the patent, the amount of depreciation allowed for any taxable year with respect to the patent generally equals the amount of the royalty paid or incurred during such year.[46]

Treatment of contracts with a stated life

A taxpayer that acquires the assets of a trade or business will often acquire rights under contracts that were entered into by the seller of the trade or business with third parties.[47] For example, the buyer may step into the shoes of the seller with respect to a supply contract that grants the buyer more favorable terms than the buyer could obtain on its own with respect to the subject matter of the contract.[48] The portion of the purchase price of an acquired trade or business that is assigned to a favorable contract may be amortized for Federal income tax purposes if the buyer establishes that (1) the contract has a limited useful life, the duration of which can be established with reasonable accuracy, and (2) the contract has an ascertainable value that is separate and distinct from goodwill.[49]

Taxpayers have successfully demonstrated that contracts to acquire supplies at a specific price are separate and distinct from goodwill or going concern value even though the supplies that are the subject of the contract were essential to the operation of the taxpayers' trade or business.[50] However, taxpayers have had mixed results in demonstrating that acquired contracts had limited useful lives, particularly where the contracts are renewable. The probability of future renewals generally is a question of fact.[51]

For example, in *Westinghouse Broadcasting Corp. v. Commissioner*,[52] the Court of Appeals for the Third Circuit held that a television network affiliation contract that had a term of two years, but was automatically renewable an indefinite number of times, had an indefinite life and was not subject to amortization. As a further

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[46] See, e.g., *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945) (acq.); and *Newton Insert Co. v. Commissioner*, 61 T.C. 570 (1974), *aff'd per curiam*, 545 F.2d 1259 (9th Cir. 1976).

[47] In addition, a taxpayer may incur costs in connection with entering into a contract. These costs generally must be capitalized and amortized over the life of the contract. For example, Treasury regulation section 1.162-11 and Code section 178 generally provide that costs incurred to acquire a leasehold interest must be capitalized and amortized over the term of the lease, in certain cases taking into account renewal options.

[48] Taxpayers also have assigned valued to, and claimed amortization deductions with respect to, contracts for which the taxpayer provides goods or services to third parties. Some courts have allowed amortization deductions with respect to these customer-based contracts, while others have held such contracts to be analogous to goodwill. Compare *Commissioner v. Seaboard Finance Co.*, 367 F.2d 646 (9th Cir. 1966) (amortization deductions allowed with respect to consumer term loans) with *U.S. Industrial Alcohol Co. v. Commissioner*, 137 F.2d 511 (2nd Cir. 1943) (amortization deductions not allowed with respect to contracts to supply products to customers because such contracts were akin to goodwill). For a discussion of customer-based intangibles, see above.

[49] *Southern Bancorporation, Inc. v. Commissioner*, 847 F.2d 131, 136–137 (4th Cir. 1988).

[50] See, e.g., *Triangle Publications, Inc. v. Commissioner*, 54 T.C. 138 (1970); and *Ithaca Industries, Inc. v. Commissioner*, 97 T.C. No. 16 (August 12, 1991).

[51] *Toledo TV Cable Co. v. Commissioner*, 55 T.C. 1107, 1117 (1971), *aff'd. per curiam*, 483 F.2d 1398 (9th Cir. 1973).

[52] 309 F.2d 279 (3rd Cir. 1962), *cert. denied*, 372 U.S. 935.

Prior to the adoption of the present-law rules, goodwill and going concern value were not explicitly required to be considered a "residual" category. Rather, some taxpayers would separately identify an initial value for such assets along with values for all other assets. In cases where taxpayers contended that they had paid a "premium" price, (i.e., an amount greater than the value of all the assets), some taxpayers interpreted the law to permit allocating this residual amount proportionately among all assets, with the result that the depreciable value of some assets would exceed their identified fair market value.

Present law expressly requires any excess purchase price over the identified fair market value of depreciable assets to be allocated entirely to nondepreciable goodwill or going concern value. However, present law does not generally provide any statutory limits on the extent to which purchase price may be allocated to amortizable assets rather than to nonamortizable goodwill or going concern value.[56] Present law also does not provide a method for allocating purchase price among amortizable assets. Thus, disputes often arise under present law over whether the value of particular amortizable assets are "overstated" or "understated." Present law also does not provide rules other than facts and circumstances for determining whether the taxpayer has made a "premium" purchase (with resulting nonamortizable goodwill or going concern value) or a "bargain" purchase (in which case some taxpayers may argue that they obtained amortizable assets for less than fair market value and, under the priority allocation rules, are thus entitled to allocate virtually nothing to goodwill or going concern value).

Present law contains reporting rules, requiring the buyer and seller of assets to report the values allocated to various assets or categories of assets to the extent required by Treasury Department regulations (sec. 1060(b)). The Code does not contain an explicit penalty that applies if the buyer and seller do not allocate the same amounts to the same assets. However, if, in connection with an acquisition, the transferor and transferee agree in writing as to the allocation of any consideration or the fair market value of any assets, neither of the parties may thereafter challenge the allocation unless the Secretary of the Treasury determines the allocation is not appropriate (sec. 1060(a)). Reporting is also required, as prescribed by Treasury Department regulations, if, in connection with the transfer of certain interests in an entity, there is also a covenant not to compete or other agreement with the transferee (sec. 1060(e)).

Taxpayers have used different methods to value intangible assets. Such methods include a replacement cost approach ("cost"), a comparable transactions (or "market") approach (if there is a comparable intangible that is sold between unrelated parties), and an approach based on the allocation of a portion of estimated future earnings to a particular intangible and discounting such earnings to their present value ("future earnings"). With respect to

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[56] Section 1056 of the Internal Revenue Code creates a presumption that no more than 50 percent of the purchase price for a professional sports franchise is allocable to amortizable player contracts.

a single business acquisition, some intangibles may be valued by one method and others by another. In addition, different acquirers may use different methods to value similar types of intangibles.

Disputes may arise over any aspect of the allocation, including whether a particular asset should properly be valued based on cost, on market, or on future earnings. If a cost method is used, there may be disputes regarding how that cost is determined and what expenses should be taken into account in determining the cost. If a market approach is used, there may be disputes regarding whether there are in fact comparable arm's length transactions. If an earnings method is used, there may be disputes regarding what portion of future earnings should be allocated to one intangible rather than to another, and what discount rate should be used to determine present value.

In litigation, taxpayers and the Internal Revenue Service typically produce expert testimony regarding the valuation of particular assets. Frequently, the experts disagree about particular valuations. Moreover, the several experts for one party may not be in complete agreement regarding valuations.

Comparison of present-law treatment of tangible property

The rules governing the depreciation or amortization of intangible property differ from the rules governing the depreciation of tangible property, which have evolved over many years. Under the present-law rules applicable to tangible property, specific lives are assigned to specific types of depreciable property. The experience of a particular business enterprise or a particular taxpayer with respect to the life of an asset generally is not relevant.

Originally, tangible property depreciation rules were similar to the present-law rules governing intangibles. Tangible property depreciation was determined based on the facts and circumstances of each case. The rules later evolved to permit the use of guideline lives without precluding taxpayers from showing a shorter life. In the past decade, the use of specified lives became mandatory for tangible assets.[57] Issues may still arise regarding the allocation of purchase price among tangible assets (for example, between a building, which is depreciable, and land, which is not). However, the adoption of specified lives and methods generally has eliminated disputes concerning the depreciation of tangible property, regardless of whether such lives and methods corresponds to any taxpayer's actual experience.

Treatment of self-created assets

Taxpayers are allowed a deduction for all the ordinary and necessary expenses that are paid or incurred during a taxable year in carrying on any trade or business (sec. 162(a)). However, taxpayers generally may not deduct currently the costs of acquiring, permanently improving, or increasing the value of any property (sec.

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[57] For a more extensive discussion of the history of tangible asset depreciation, see the GAO Report, *supra* n. 26, pp. 16-18. In the case of tangible property, the specified lives often were designed to contain an incentive accelerated depreciation element.

263(a)). These costs generally must be capitalized.[58] In addition, the direct and indirect costs of a taxpayer that are allocable to property that is acquired by the taxpayer for resale or that are allocable to certain real or tangible personal property produced by the taxpayer must be included in inventory or capitalized (sec. 263A).[59]

Costs that are paid or incurred to acquire an intangible asset generally must be capitalized. However, some costs that are paid or incurred to create, maintain, or enhance the value of certain intangible assets may be deducted as ordinary and necessary business expenses for the year that the costs are paid or incurred.[60] For example, advertising expenses generally may be deducted for the year paid or incurred.[61] Likewise, costs incurred to train employees generally may be deducted for the year such costs are paid or incurred even though the training results in a more knowledgeable or valuable workforce.[62] Thus, although taxpayers generally must capitalize the costs of acquiring intangible assets from another person (such as the costs of acquiring a customer list or goodwill), taxpayers generally may currently deduct the costs incurred to develop or maintain such intangible assets.

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[58] See, e.g., *American Seating Co. v. Commissioner*, 4 B.T.A. 1588 (1926) (amounts paid for exclusive licenses for use of designs and inventions must be capitalized); *KWTX Broadcasting Company, Inc. v. Commissioner*, 31 T.C. 952 (1959) *aff'd per curiam*, 272 F.2d 406 (5th Cir. 1959) (costs incurred to obtain a television construction permit and broadcasting licenses were capital expenditures); and *Manhattan Co. of Virginia, Inc. v. Commissioner*, 50 T.C. 78 (1968) (a customer list purchased by a laundry was an intangible asset, the cost of which must be capitalized).

[59] For this purpose, the term "tangible personal property" includes a film, sound recording, video tape, book or similar property.

[60] Section 174 of the Code also permits the immediate deduction of research and experimental costs that contribute to the creation of intangibles such as technology and similar items. However, a taxpayer who purchases such intangibles from another taxpayer must capitalize the price paid and amortize it over the useful life of the asset if one can be shown.

[61] See, e.g., Treas. Reg. sec. 1.162-20(a)(2).

[62] See, e.g., *Knoxville Iron Co. v. Commissioner*, 18 T.C.M. 251 (1959) (training costs held to be deductible when incurred); and *Cleveland Electric Illuminating Co. v. Commissioner*, 7 Cl. Ct. 220 (1985) (certain training costs were deductible when incurred; other training costs required to be capitalized because the costs related to the start-up of a new business).

III. DESCRIPTION OF PROPOSALS

A. H.R. 3035 (Chairman Rostenkowski)

Explanation of the Bill

Overview

H.R. 3035 would allow an amortization deduction with respect to certain intangible property (defined as a "section 197 intangible") that is acquired by a taxpayer and that is held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. The amount of the deduction would be determined by amortizing the adjusted basis (for purposes of determining gain) of the intangible ratably over a 14-year period that begins with the month that the intangible is acquired. No other depreciation or amortization deduction would be allowed with respect to a section 197 intangible that is acquired by a taxpayer and that is held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income.

The bill generally would apply to a section 197 intangible whether it is acquired as part of a trade or business or as a single preexisting asset. The bill generally would not apply to a section 197 intangible that is created by the taxpayer or that arises solely by reason of the entering into (or renewal) of a contract to which the taxpayer is a party.[63]

Definition of section 197 intangible

In general

The term "section 197 intangible" would be defined as: (1) goodwill; (2) going concern value; (3) certain specified types of intangible property that generally relate to workforce, information base, know-how, customers, suppliers, or other similar items; (4) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof (except for rights of an indefinite duration as described below); (5) any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (6) any franchise, trademark, or trade name.

The term "section 197 intangible" would not include: (1) any property of a kind that is regularly traded on an established

[63] As more fully described below, the bill would apply to certain licenses, franchises, and covenants not to compete that are created by the taxpayer or that arise solely by reason of the entering into (or renewal) of a contract to which the taxpayer is a party.

market; (2) a patent or copyright that is not acquired in a transaction (or a series of related transactions) involving the acquisition of a trade or business (or a substantial portion thereof); (3) a franchise to engage in any professional sport, and any item acquired in connection with such a franchise; and (4) any license, permit, or other right of an indefinite duration that is granted by a governmental unit or an agency or instrumentality thereof. In addition, the bill would authorize the Treasury Department to issue regulations to exclude from the definition of a section 197 intangible certain fixed-term contract rights that are not acquired in a transaction (or a series of related transactions) involving the acquisition of a trade or business (or a substantial portion thereof).

Goodwill and going concern value

For purposes of the bill, goodwill would be defined as the value of a trade or business that is attributable to the expectancy of continued customer patronage, whether due to the location of a trade or business, the name of a trade or business, the reputation of a trade or business, or any other factor.

In addition, for purposes of the bill, going concern value would be defined as the additional element of value of a trade or business that attaches to property by reason of its existence as an integral part of a going concern. Going concern value for this purpose would include the value that is attributable to the ability of a trade or business to continue to function and generate sales without interruption notwithstanding a change in ownership and the value that is attributable to immediate use or availability of acquired property of a trade or business (e.g., the net earnings that would otherwise not be received during any period were the acquired property not operational).

Workforce in place

The term "section 197 intangible" would include workforce in place (which is sometimes referred to as agency force or assembled workforce), the composition of a workforce (for example, the experience, education, or training of a workforce), and the terms and conditions of employment whether contractual or otherwise. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a highly-skilled workforce would be amortized over the 14-year period specified in the bill. As a further example, the cost of acquiring an existing employment contract (or contracts) would be amortized over the 14-year period specified in the bill.

Information base

The term "section 197 intangible" would also include business books and records, operating systems, and any other information base including lists or other information with respect to current or prospective customers. Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems would be amortized over the 14-year period specified in the bill. As a further example, the cost of acquiring customer lists, sub-

scription lists, insurance expirations, patient or client files, credit information, or lists of newspaper, magazine, radio or television advertisers would be amortized over the 14-year period specified in the bill.

Know-how and similar items

The term "section 197 intangible" would also include any formula, process, design, pattern, know-how, format, or other similar item. Thus, for example, the portion of the cost of acquiring existing software, films, sound recordings, video tapes, brochures, catalogues, or package designs that is attributable to the intangible value of such property would be amortized over the 14-year period specified in the bill.

Customer-based intangibles

The term "section 197 intangible" would also include any customer-based intangible, which would be defined as composition of market, market share, and any other value resulting from the future provision of goods or services pursuant to relationships with customers (contractual or otherwise) in the ordinary course of business.

Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of customer base, circulation base, undeveloped market or market growth, order backlog, insurance in force, mortgage servicing contracts, investment management contracts, or other contracts with customers that involve the future provision of goods or services, would be amortized over the 14-year period specified in the bill. On the other hand, the portion (if any) of the purchase price of an acquired trade or business that is attributable to accounts receivable or other similar rights to income for goods or services provided to customers prior to the acquisition of a trade or business would not be taken into account under the bill.[64]

In addition, the term "customer-based intangible" would not include any interest as a lessor under a lease of tangible property (whether real or personal) if the interest as a lessor is acquired by the taxpayer in connection with the acquisition of the tangible property. Consequently, the premium paid to acquire the right to receive an above-market rate of rent under a lease of tangible property (where the right to receive the rent is acquired in connection with the tangible property) would be taken into account under the principles of present law, which generally require the premium to be added to the basis of the property and recovered over the useful life of the property.[65]

Further, although a bank or other financial institution may be engaged in the provision of loans to customers in the ordinary course of business, the term "customer-based intangible" would not

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[64] As under present law, the portion of the purchase price of an acquired trade or business that is attributable to accounts receivable would be allocated among each receivable and would be recovered as payment is received under the receivable or at the time that the receivable becomes worthless.

[65] See *Schubert v. Commissioner*, 33 T.C. 1048 (1960), *aff'd*, 286 F.2d 573 (4th Cir.), *cert. denied*, 366 U.S. 960 (1961); and *American Controlled Indus., Inc. v. United States*, 55 AFTR 2d 947 (S.D. Ohio 1984).

include any interest as a creditor under any indebtedness that was in existence on the date that the interest was acquired. Consequently, the premium paid for acquiring the right to receive an above-market rate of interest under a debt instrument may be taken into account under section 171 of the Code, which generally allows the amount of the premium to be amortized on a yield-to-maturity basis over the remaining term of the debt instrument.

Finally, the term "customer-based intangible" would include the deposit base or other similar items of a financial institution.

Supplier-based intangibles

The term "section 197 intangible" would also include any supplier-based intangible, which would be defined as the value resulting from the future acquisition of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer.

Thus, for example, the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a favorable relationship with persons that provide distribution services or the existence of favorable supply contracts, would be amortized over the 14-year period specified in the bill. On the other hand, the portion (if any) of the purchase price of an acquired trade or business that is attributable to stocks, bonds, partnership interests, and other securities would not be taken into account under the bill because the value of these intangible interests does not result from the future acquisition of goods or services pursuant to relationships in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer.

The term "supplier-based intangible" would include any interest as a lessee under a lease,[66] except that the term would not include any interest as a lessee under a lease of tangible property (whether real or personal) if (1) the lease has a fixed duration and is not renewable, and (2) the interest is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business (or a substantial portion thereof).[67] Thus, for example, the cost of acquiring rights as a lessee under an existing 10-year lease of real property that is non-renewable would be taken into account under present law (see Treas. Reg. sec. 1.162-11(a)) rather than under the provisions of the bill, provided that the rights under the lease are not acquired in a transaction (or series of related transactions) that involves the acquisition of assets which constitute a trade or business (or a substantial portion thereof).

In addition, the term "supplier-based intangible" would include any interest as a debtor under any indebtedness (for example, indebtedness with a below-market interest rate), except that the term would not include any interest as a debtor under any indebtedness

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[66] If an interest as a lessee under a lease is a section 197 intangible, no deduction would be allowed for the cost of acquiring such interest other than pursuant to the provisions of the bill (i.e., no deduction would be allowed under Treas. Reg. sec. 1.162-11(a)).

[67] For purposes of the bill, the acquisition of a franchise, trademark, or trade name would be considered the acquisition of assets which constitute a trade or business (or a substantial portion thereof).

that (1) was in existence on the date that the interest was acquired and (2) has a fixed duration and is not renewable.

Finally, the term "supplier-based intangible" would not include any interest in land (including an interest as a lessee) unless such interest is depreciable or amortizable (without regard to the bill) over a period of less than 30 years as of the date that the interest is acquired.[68]

Licenses, permits, and other rights granted by governmental units

The term "section 197 intangible" would also include any license, permit, or other right granted by a governmental unit or any agency or instrumentality thereof, except that the term would not include governmental rights of an indefinite duration as more fully described below. Thus, for example, the cost of acquiring from any person a right originally granted by a governmental unit to engage in an activity would be taken into account under the bill, except if the right is of an indefinite duration as specified below. For purposes of the bill, the renewal of a license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof would be considered an acquisition of such license, permit, or other right.

Covenants not to compete and other similar arrangements

The term "section 197 intangible" would also include any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof). For this purpose, an interest in a trade or business would include not only the assets of a trade or business,[69] but also stock in a corporation that is engaged in a trade or business or an interest in a partnership that is engaged in a trade or business.

Any amount that is paid or incurred under a covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof) would be chargeable to capital account and would be amortized ratably over the 14-year period specified in the bill.

For purposes of this provision, an arrangement that requires the former owner of an interest in a trade or business to continue to perform services that benefit the trade or business would be considered to have substantially the same effect as a covenant not to compete to the extent that the amount paid to the former owner under the arrangement exceeds the amount that represents reasonable compensation for the services actually rendered by the former

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[68] For purposes of this exception, the deduction allowed under Treas. Reg. sec. 1.162-11(a) would be considered an amortization deduction.

[69] For purposes of the definition of a section 197 intangible, a group of assets would constitute a trade or business if the use of such assets would constitute a trade or business for purposes of section 1060 (i.e., if the assets are of such a character that goodwill or going concern value could under any circumstances attach to the assets). In addition, any franchise, trademark or trade name would constitute a trade or business (or a substantial portion thereof) for this purpose.

owner. As under present law, to the extent that the amount paid or incurred under a covenant not to compete or other similar arrangement represents additional consideration for the acquisition of stock in a corporation, such amount would not to be taken into account under the bill but, instead, would be included as part of the acquiror's basis in the stock.

Franchises, trademarks, and trade names

The term "section 197 intangible" would also include any franchise, trademark, or trade name. For purposes of the definition of a section 197 intangible, the term "franchise" would be defined to include any agreement that provides one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area, except that the term would not include any right granted by a governmental unit or an agency or instrumentality thereof.[70] In addition, as provided under present law, the renewal of a franchise, trademark, or trade name would be treated as an acquisition of such franchise, trademark, or trade name.[71]

The bill would continue the present-law treatment of certain contingent amounts that are paid or incurred on account of the transfer of a franchise, trademark, or trade name. Under these rules, a deduction is allowed for amounts that are contingent on the productivity, use, or disposition of a franchise, trademark, or trade name only if (1) the contingent amounts are paid as part of a series of payments that are payable at least annually throughout the term of the transfer agreement, and (2) the payments are substantially equal in amount or payable under a fixed formula. Any other amount, whether fixed or contingent, that is paid or incurred on account of the transfer of a franchise, trademark, or trade name would be chargeable to capital account and would be amortized ratably over the 14-year period specified in the bill.

Exceptions to the definition of a section 197 intangible

Property regularly traded on an established market.—The term "section 197 intangible" would not include any property of a kind that is regularly traded on an established market. Thus, for example, the cost of acquiring an existing futures contract, foreign currency contract, notional principal contract, or other similar contract of a kind that is regularly traded on an established market would not be taken into account under the bill.

Certain patents and copyrights.—The term "section 197 intangible" would not include any patent or copyright if the patent or copyright is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or busi-

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[70] As explained above, any license, permit, or other right granted by a governmental unit or any agency or instrumentality thereof would be a section 197 intangible, except if the license, permit, or other right is of an indefinite duration.

[71] Only the costs incurred in connection with the renewal, however, would be amortized over the 14-year period that begins with the month that the franchise, trademark, or trade name is renewed. Any costs incurred in connection with the issuance (or an earlier renewal) of a franchise, trademark, or trade name would continue to be taken into account over the remaining portion of the amortization period that began at the time of such issuance (or earlier renewal).

ness (including the acquisition of a franchise, trademark, or trade name). Instead, the provisions of present law would continue to apply. A patent or copyright that is acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion thereof, however, would be subject to the provisions of the bill.

Professional sports franchises.—A franchise to engage in a professional baseball, basketball, football, or other professional sport, and any item acquired in connection with such a franchise would be excluded from the definition of a section 197 intangible. Consequently, the cost of acquiring a professional sports franchise and related assets would be allocated among the assets acquired as provided under present law (see, for example, section 1056), and would be taken into account under the provisions of present law.

Governmental rights of an indefinite duration.—The term "section 197 intangible" would not include any license, permit, or other right that is granted by a governmental unit or an agency or instrumentality thereof if the right is granted for an indefinite period or the right is reasonably expected to be renewed for an indefinite period. In determining whether a license, permit, or other right that is acquired from another person (other than the governmental entity that granted the right) is reasonably expected to be renewed for an indefinite period, one factor that would be taken into account is the cost of acquiring the right as compared to the cost incurred in connection with the original grant (or renewal) of the right.[72]

Certain contract rights.—In addition, to the extent provided in regulations to be promulgated by the Treasury Department, the term "section 197 intangible" would not include any right under a contract (or any right granted by a governmental unit or an agency or instrumentality thereof) if the right has a fixed duration and is not renewable and the right is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business (including the acquisition of a franchise, trademark, or trade name).

Exclusion for certain self-created intangibles

The bill generally would not apply to any section 197 intangible that is created by the taxpayer or that arises solely by reason of the entering into (or renewal) of a contract to which the taxpayer is a party. Thus, for example, the bill would not apply to the costs incurred by a lessee in connection with the entering into (or renewal) of a lease or the costs incurred by a licensee in connection with the entering into (or renewal) of a license of any property other than a pre-existing section 197 intangible (for example, a license of pre-existing software or other know-how).[73]

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[72] Cf. *Nachman v. Commissioner*, 191 F.2d 934 (5th Cir. 1951) (amount paid for one-year city liquor license, which was acquired for $8,000 but which cost the original licensee $750, was not amortizable because license carried a valuable renewal privilege).

[73] These costs would continue to be taken into account under present law, which generally requires the costs to be recovered over the term of the lease (or license) if the lease (or license) has a definite term. (See Treas. Reg. sec. 1.162-11(a).)

On the other hand, the bill would apply to the cost of acquiring rights as a lessee under an existing lease (if the rights under the lease are acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business) and the cost of acquiring rights as a licensee under an existing license of any property.

Notwithstanding the above, this exception for "self-created" intangibles would not apply to: (1) any license, permit, or other right that is granted by a governmental unit or an agency or instrumentality thereof; (2) any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (3) any franchise, trademark, or trade name. Thus, for example, the cost of obtaining a license from the government (other than a license of indefinite duration) or the cost of obtaining a franchise from the franchisor would be amortized over the 14-year period specified in the bill.

Special rules

Determination of adjusted basis

The adjusted basis of a section 197 intangible that is acquired from another person generally would be determined under the principles of present law that apply to tangible property that is acquired from another person. Thus, for example, if a portion of the cost of acquiring an amortizable section 197 intangible is contingent, the adjusted basis of the section 197 intangible would be increased as of the beginning of the month that the contingent amount is paid or incurred. This additional amount would be amortized over the remaining months in the 14-year amortization period that applies to the intangible as of the beginning of the month that the contingent amount is paid or incurred. In addition, any expenditure that is directly connected with the protection, registration, or defense of a previously acquired section 197 intangible would not be taken into account under the bill, but, instead, would be taken into account under present law.

Treatment of certain dispositions of amortizable Section 197 intangibles

Special rules would apply if a taxpayer disposes of a section 197 intangible that was acquired in a transaction or series of related transactions (or any such intangible becomes worthless) and, after the disposition (or the event that rendered the intangible worthless), the taxpayer retains other section 197 intangibles that were acquired in such transaction or series or related transactions. First, no loss would be recognized by reason of the disposition (or worthlessness). Second, the adjusted bases of the retained section 197 intangibles that were acquired in connection with such transaction or series of related transactions would be increased by the amount of any loss that is not recognized. The adjusted basis of any such retained section 197 intangible would be increased by the product of (1) the amount of the loss that is not recognized solely by reason of this provision, and (2) a fraction, the numerator of which is the

adjusted basis of the intangible as of the date of the disposition (or worthlessness) and the denominator of which is the total adjusted bases of all such retained section 197 intangibles as of the date of the disposition (or worthlessness).

Treatment of certain nonrecognition transactions

If any section 197 intangible is acquired in a transaction to which section 332, 351, 361, 721, or 731 applies (or any transaction between members of the same affiliated group during any taxable year for which a consolidated return is filed),[74] the transferee would be treated as the transferor for purposes of applying the bill to the amount of the adjusted basis of the transferee that does not exceed the adjusted basis of the transferor.

Treatment of insurance contracts

The bill would apply to any insurance contract that is acquired from another person through an assumption reinsurance transaction (but not through an indemnity reinsurance transaction).[75] The amount taken into account as the adjusted basis of such a section 197 intangible, however, would equal the excess of (1) the amount paid or incurred by the acquirer/reinsurer under the assumption reinsurance transaction,[76] over (2) the amount of the specified policy acquisition expenses (as determined under sec. 848) that is attributable to premiums received under the assumption reinsurance transaction. The amount of the specified policy acquisition expenses of an insurance company that is attributable to premiums received under an assumption reinsurance transaction would be amortized over the period specified in section 848.

Regulatory authority

The Treasury Department would be authorized to prescribe such regulations as may be appropriate to carry out the purposes of the bill, including regulations that clarify the types of intangible property that constitute section 197 intangibles.

Effective Date

H.R. 3035 would apply to property acquired after the date of enactment of the bill. Special rules would be provided to prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction is not allowable under present law into amortizable property to which the bill would apply.

Under these "anti-churning" rules, goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provi-

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[74] The termination of a partnership under section 708(b)(1)(B) would not be included in the transactions to which this rule applies.

[75] An assumption reinsurance transaction is an arrangement whereby one insurance company (the reinsurer) becomes solely liable to policyholders on contracts transferred by another insurance company (the ceding company). In addition, for purposes of the bill, an assumption reinsurance transaction would include any acquisition of an insurance contract that is treated as occurring by reason of an election under section 338 of the Code.

[76] The amount paid or incurred by the acquirer/reinsurer under an assumption reinsurance transaction would be determined under the principles of present law. See Treas. Reg. sec. 1.817-4(d)(2).

sions of the bill, that is acquired by a taxpayer after the date of enactment of the bill would not be amortized under the bill if: (1) the taxpayer or a related person held or used the intangible at any time on or before the date of enactment of the bill; (2) the taxpayer acquired the intangible from a person that held such intangible at any time on or before the date of enactment of the bill and, as part of the transaction, the user of the intangible does not change; or (3) the taxpayer grants the right to use the intangible to a person (or a person related to such person) that held or used the intangible at any time on or before the date of enactment of the bill. These anti-churning rules, however, would not apply to the acquisition of any intangible by a taxpayer if the basis of the intangible in the hands of the taxpayer is determined under section 1014(a) (relating to property acquired from a decedent).

For purposes of these anti-churning rules, a person would be considered related to another person if: (1) the person bears a relationship to that person which is specified in section 267(b)(1) or 707(b)(1) by substituting 10 percent for 50 percent; or (2) the persons are engaged in trades or businesses under common control within the meaning of sections 52(a) and (b). The determination of whether a person is related to another person would be made at the time that the taxpayer acquires the intangible involved, except that in the case of an acquisition of an intangible by any partnership which results from the termination of another partnership under section 708(b)(1)(B), the determination would be made immediately before the termination occurs.

The bill would also provide a general anti-abuse rule that would apply to any section 197 intangible that is acquired by a taxpayer from another person. Under this rule, a section 197 intangible would not be amortized under the provisions of the bill if the taxpayer acquired the intangible in a transaction one of the principal purposes of which is to (1) avoid the requirement that the intangible be acquired after the date of enactment of the bill or (2) avoid any of the anti-churning rules described above that are applicable to goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill.

Finally, the special rules described above that apply in the case of a transactions described in section 332, 351, 361, 721, or 731 would also apply for purposes of the effective date. Consequently, if the transferor of any section 197 property would not be allowed an amortization deduction with respect to such property under the bill, then the transferee would not be allowed an amortization deduction under the bill to the extent of the adjusted basis of the transferee that does not exceed the adjusted basis of the transferor.

B. H.R. 1456 (Mr. Vander Jagt, Mr. Anthony, and Mrs. Kennelly)

Explanation of the Bill

H.R. 1456, the "Intangibles Amortization Clarification Act of 1991," would amend section 167 to provide that the value of customer based, market share, and any similar intangible items are amortizable over their useful life if the taxpayer may demonstrate through any reasonable method that (1) the intangible items have an ascertainable value that is separate and distinct from other assets (including goodwill and going concern value), if any, acquired as part of the same transaction, and (2) the intangible items have a limited useful life, the length of which may be reasonably estimated.

In addition, H.R. 1456 would grant the Treasury Department the authority to promulgate regulations establishing safe harbor recovery periods that are consistent with industry practice and experience for specific types of customer based, market share, and any similar intangible items, and regulations concerning the manner in which such intangible items may be valued separately and distinctly from other assets (including goodwill and going concern value).

Effective Date

H.R. 1456 would apply to all open taxable years (i.e., all taxable years for which the statute of limitations has not expired).

C. H.R. 563 (Mr. Donnelly)

Explanation of the Bill

H.R. 563 would amend section 167 to provide that in determining whether an income tax deduction is allowed for any amount that is paid or incurred to acquire customer base, market share, or any similar intangible item, the amount is to be treated as paid or incurred for intangible property with an indeterminate useful life. Consequently, no depreciation or amortization deduction would be allowed under the bill for the cost of acquiring customer and subscription lists; patient or other records; the existing "core" deposits of banks; insurance in force in the case of an insurance company; advertising relationships and customer or circulation base in the case of a broadcast, cable, newspaper, cellular, or any other business; other contracts or relationships reflecting the value of the customer base; location advantage; workforce in place; and market share.

Effective Date

H.R. 563 would apply to acquisitions that occur after the date of enactment.

IV. ISSUES REGARDING THE FEDERAL INCOME TAX TREATMENT OF INTANGIBLE ASSETS

A. Treatment of Intangible Assets in General

Theoretically, any decline in the values of both tangible and intangible assets should be reflected in the measurement of taxable income derived from a trade or business. More accurate measures of the declines (and increases as well) in the values of assets would lead to more accurate measures of taxable income. Generally, the most accurate method of measuring taxable income would involve marking the value of the tangible or intangible assets to market each accounting period. However, such an approach would involve difficulties in identifying accurate values, particularly for assets that are not regularly traded. In addition, a mark-to-market system would involve significant complexity and compliance burdens.

Instead, depreciation or amortization allowances are typically determined based on an approximation of the expected decline in the value of the assets used in a trade or business. Theoretically, the most accurate of these schedules for both tangible and intangible assets would be unique to each business, so that different taxpayers would have different schedules for identical assets.[77] However, the use of a taxpayer-by-taxpayer facts and circumstances determination of depreciation for Federal income tax purposes has resulted in numerous disputes between taxpayers and the Internal Revenue Service.[78]

In accounting for the decline in value of an asset, it is generally necessary to identify three items: valuation (or cost), useful life, and rate of decline in value. Some tangible assets trade in markets on a stand-alone basis, allowing reasonably well-settled, unbiased estimates of the market value for those tangible assets not acquired on a stand-alone basis.[79] In addition, tangible assets are often relatively easy to classify into homogeneous groups, which may be treated in a like manner. If there is an active secondary market for tangible assets, it is possible to observe the decline in the market prices of representative assets. This, in turn, permits objective estimates to be made of the useful life and the schedule of economic decline for these assets. Such schedules can be used as a basis for providing depreciation schedules for similar assets for Federal income tax purposes and to provide certainty to taxpayers

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[77] For example, a truck rented on a weekly basis to multiple users would likely experience a different pattern of decline in economic value than a similar truck used solely by an owner-operator in a wholesale business.

[78] See H.R. Rep. No. 1337, 83rd Cong., 2nd Sess. 22 (1954) for a discussion of the controversies surrounding the interpretation of "reasonable allowance for depreciation."

[79] Note that it is rather easy to value single assets acquired on a stand-alone basis by simply looking at the price paid by a willing buyer to a willing seller. However, defining exactly what constitutes a single asset (e.g., the bundle of property rights that makes up a single asset) and defining what constitutes a stand-alone acquisition may be difficult in particular situations.

as to the amount of depreciation deductions allowable for any asset for any taxable period.[80]

In contrast, intangible assets have often been considered harder to classify into homogeneous groups because the use of these assets depends to a large extent on the actual owner of the asset. Moreover, the valuation of intangible assets is problematic because competitive markets for these assets frequently do not exist. The lack of a market for either new or used intangible assets generally means that it is not possible to observe the decline in market prices as a means to determine the useful life or the schedule of decline in the economic value for these assets.[81] This difference from tangible assets could arguably justify a different treatment for cost recovery purposes.[82]

B. Treatment of Goodwill and Going Concern Value

The three bills differ in the scope of the assets they address. In this connection, one of the differences among the three bills is the treatment of goodwill and going concern value (hereinafter together referred to as "goodwill"). As discussed in Part II above, goodwill is not amortizable under present law. H.R. 563 would not only retain this treatment for goodwill, it would also require similar treatment for all customer-based and similar intangible assets (regardless of whether a separate value and life might otherwise be identified). H.R. 1456 would also retain the present-law treatment of goodwill, but would provide that a customer-based intangible asset is amortizable if the taxpayer can demonstrate through any reasonable method that (1) the asset has an ascertainable value separate and distinct from other assets (including goodwill) acquired as part of the same transaction and (2) the asset has a limited useful life, the length of which can be reasonably estimated. H.R. 3035, on the other hand, would allow taxpayers to amortize the cost of acquired goodwill in the same manner and over the same period as other acquired intangible assets.

One consideration to be taken into account in determining whether goodwill should be amortized for Federal income tax purposes is whether the amortization of goodwill would provide a more accurate measure of economic income.

It may be argued that goodwill is not a wasting asset and, thus, amortization deductions should not be allowed with respect to goodwill. Alternatively, it may be argued that as long as current deductions are allowed for the costs associated with maintaining the value of goodwill, the amortization of the costs of acquired goodwill is not required in order to provide an accurate measure of economic income. For example, assume that a taxpayer acquires all the assets of a business, one of which is goodwill. Further, assume that

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[80] See, e.g., Rev. Proc. 87-56, 1987-2 C.B. 674, for the class lives and recovery periods for various tangible assets and Rev. Proc. 87-57, 1987-2 C.B. 687, for the depreciation allowances provided for tangible assets of various recovery periods.

[81] Further discussion of problems encountered in the valuation of intangible assets may be found in "A Study of Intercompany Pricing," the 1988 Treasury White Paper.

[82] Under present law, the costs of tangible and intangible assets are recovered differently. The costs of tangible assets generally are recovered pursuant to the lives, methods, and conventions prescribed by section 168. However, the costs of amortizable intangible assets generally are recovered pursuant to methods and periods established as appropriate on the basis of the facts and circumstances of the taxpayers holding such assets.

the taxpayer engages in advertising and incurs other expenditures in the operation of its business that in part preserve the value of this goodwill. Under present law, the amortization of the acquired goodwill is not allowed while the advertising and other business expenses are currently deductible. It may be argued that income is properly measured under present law because although goodwill may be a wasting asset, the currently deducted costs restore the value of the goodwill. The basis for this argument is that theoretically expenses attributable to replacing goodwill should be capitalized and amortized over the life of the goodwill and that as long as this is not required, denying amortization for goodwill is appropriate even if goodwill is a wasting asset.

On the other hand, it may be argued that goodwill is, in fact, a wasting asset and, thus, should be treated as such for Federal income tax purposes. For example, goodwill has been defined as "the expectancy of continued patronage," [83] or "the expectancy that the old customers will resort to the old place." [84] Clearly a business that has loyal customers is more valuable than a business that does not. However, this customer loyalty cannot reasonably be expected to last forever as customers relocate or die, or have needs or tastes that change over time.[85] Customer loyalty would also be expected to decline faster if a business does not take steps to continue to satisfy existing or changing customer needs (e.g. by maintaining or expanding its level of service). It may be argued that goodwill is not amortizable under present law principally because taxpayers cannot overcome their burden of showing over what period goodwill wastes. Thus, specifying a recovery period for the cost of goodwill is arguably appropriate in that it would provide a measure of "rough justice."

It may further be argued that permitting the deduction of costs that may contribute to the replacement of diminishing goodwill does not justify denying a deduction for goodwill. Both creators and purchasers of businesses with goodwill deduct ordinary and necessary business expenses currently and there would be significant administrative and other issues involved in attempting to identify costs to be capitalized as contributing to the creation or replacement of goodwill. Permitting a deduction for goodwill arguably would more nearly equalize the treatment of the creator and the purchaser of goodwill than does present law.

In addition, it may be argued that the amortization of goodwill is necessary to obtain the greatest degree of simplification in the tax treatment of intangible assets. Under present law, upon the acquisition of the assets of a trade or business, a taxpayer has a tax incentive to allocate as little of the purchase price of the business as possible to goodwill. This incentive has resulted in taxpayers undertaking costly and time-consuming appraisals in order to identify, allocate purchase price to, amortize, and defend the amortization of, intangible assets other than goodwill even if these other

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[83] *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962).

[84] *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1962).

[85] Those who believe that goodwill is a wasting asset point out that U.S. financial accounting rules require goodwill to be amortized. See Accounting Principles Board Opinion No. 17, requiring amortization over no more than 40 years.

assets have characteristics similar to goodwill.[86] Similar burdens are imposed on the Internal Revenue Service in connection with the examination of income tax returns that claim amortization deductions for the costs of acquired intangible assets.

The principal difference between H.R. 563 and H.R. 1456 is that H.R. 563 provides that customer-based and similar intangible assets are to be treated as goodwill as a matter of law, while H.R. 1456 provides that these intangibles are not required as a matter of law to be treated as goodwill. H.R. 3035 allows amortization deductions with respect to goodwill and generally treats goodwill and other intangible assets in the same manner for amortization purposes.

By not changing the present-law treatment of goodwill, H.R. 563 and H.R. 1456 will retain the incentive to allocate as little of the purchase price of an acquired trade or business as possible to goodwill. H.R. 563 expands to certain customer-based intangible assets the present-law disincentive to allocate value to goodwill. However, it is not clear to what extent it would change the treatment of certain other intangible assets. By allowing amortization for goodwill and other assets over the same period, H.R. 3035 would significantly lessen the incentive of taxpayers to identify assets distinct from goodwill in an attempt to obtain more favorable amortization. In some cases there may still be some incentive for taxpayers to allocate value to those identifiable assets that might be disposed of separately after an acquisition, in order to minimize any gain on such a disposition. However, the identification of amortization periods for any such assets would no longer be an issue.[87]

C. Determination of the Amortization Period and Method for Intangible Assets

Each of the three bills addresses the issue of whether the cost of intangible assets may be amortized, and, if so, over what period and under what method. H.R. 1456 would provide that customer-based or other similar intangible assets may be amortized over the useful life of the asset if a value separate from goodwill can be established. In addition, under H.R. 1456, the Treasury Department is granted regulatory authority to promulgate safe-harbor recovery periods consistent with industry practice and experience for the types of intangible assets to which the bill applies. H.R. 563 would provide that customer-based and similar intangibles may not be amortized over any period. H.R. 3035 would provide that all intangible assets to which the bill applies are to be amortized over a 14-year period using a straight-line method.

Assuming that amortization deductions are allowed for the cost of some or all intangible assets, issues arise with respect to the length of the period over which these deductions should be allowed and the method to be used (i.e., should amortization be on a straight-line method over the period or should it follow a more accelerated pattern). Specifically, issues arise as to whether the recovery period and method for an intangible asset should be (1)

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[86] See, for example, the discussion in *Newark Morning Ledger Co. v. United States*, No. 90-5637 (3rd Cir. 1991), comparing goodwill to customer lists.

[87] None of the bills would address issues regarding allocations between intangible assets and tangible assets.

based on the taxpayer's particular facts and circumstances, (2) determined pursuant to specific lives and methods provided by statute or regulations for various classes of similar types of intangible assets, or (3) a single life and method applicable to all or most intangible assets.

Facts and circumstances determination

The principal argument in favor of a facts and circumstances determination is that this method may provide the most accurate means of measuring income. It may be argued that the use of a single recovery period and method for all intangibles is arbitrary and, depending upon the length of the period and the method selected, results in some assets being amortized too quickly while others are amortized too slowly. It may also be argued that recovery periods developed pursuant to Treasury studies would likewise be somewhat arbitrary in that they would tend to average the experience of many taxpayers, where such averaging may not be reflect the situation of a particular taxpayer. For example, a customer list in an industry that undergoes frequent product innovations may have a life that is significantly different than a customer list that involves a standard product or service.

Specific separate recovery periods and methods for different assets

The adoption of specific recovery periods and methods for different types of intangible assets would follow the approach of the present-law system for tangible property. It may be argued that such a system, while admittedly not exact, could be designed to provide a reasonably appropriate matching of the cost of an asset to the periods over which it is used.[88] On the other hand, the identification of appropriate classes of intangible assets and appropriate amortization schedules could be extremely difficult, given the diversity of intangible assets that taxpayers have identified, the variety of valuation methods that have been used, and the frequent lack of comparables in the case of many intangible assets. In addition, it may be argued that to the extent any specific schedules permitted more rapid amortization for one class of assets than another, there would still be an incentive for taxpayers to allocate value to the asset with the more rapid amortization. Such allocations could be particularly difficult to police or challenge in the absence of readily identifiable market values for these assets.

Single recovery period and method

The use of a single recovery period and method for all or most intangible assets may be criticized as arbitrary. Assets that have been amortized over a longer period than the specified method under present law arguably would receive unduly favorable treatment, while assets that have been amortized over a shorter period under present law arguably would receive unduly harsh treatment.

On the other hand, it may be argued that the present-law use of taxpayer-specific facts and circumstances has resulted in conflicting results in apparently similar cases, a situation which also could

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[88] See e.g., the GAO Report, *supra* n. 26, suggesting that it would be possible to design a system with different recovery periods for different types of intangible assets.

be criticized as arbitrary. Furthermore, from a simplification standpoint, it may be argued that only a single recovery period can significantly reduce the number of amortization disputes between the IRS and taxpayers.[89]

D. Effective Dates of the Bills

H.R. 563 and H.R. 3035 would apply to intangible assets that are acquired after the dates of enactment of the respective bills. H.R. 1456 would apply to taxable years beginning before, on, or after March 18, 1991 (i.e., to all open taxable years). It has been suggested that in order to provide taxpayer certainty, avoid significant taxpayer and Government compliance and litigation costs, and alleviate current Federal court dockets, any bill simplifying the tax treatment of acquired intangible assets should either (1) be applied on a retroactive basis, or (2) provide a transition rule designed to promote the prompt resolution of disputes relating to pre-effective date acquisitions of intangible assets. It is unclear whether H.R. 1456 would effectively resolve pending disputes. It would still be necessary under H.R. 1456 to determine whether there is an identifiable asset with a determinable life and a value separate from goodwill. The retroactive application of H.R. 563 or H.R. 3035 (or a similar transition rule) would involve issues of fairness.

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[89] Under H.R. 3035, taxpayers would be required to continue to identify and value certain acquired intangible assets for purposes of determining the tax consequences on subsequent disposition of the asset. Although no loss is recognized on disposition of one asset out of a group of assets, it is necessary to determine whether gain is recognized. However, separate valuation would not generally be necessary for assets that would not likely be the subject of a separate disposition, such as goodwill or many of the other separate assets that taxpayers identify under present law.